Justice and Equity Centre

Improving the cost recovery arrangements for non-network options

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About the Justice and Equity Centre

The Justice and Equity Centre is a leading, independent law and policy centre. Established in 1982 as the Public Interest Advocacy Centre (PIAC), we work with people and communities who are marginalised and facing disadvantage.

The Centre tackles injustice and inequality through:

- legal advice and representation, specialising in test cases and strategic casework;
- research, analysis and policy development; and
- advocacy for systems change to deliver social justice.

Energy and Water Justice

Our Energy and Water Justice work improves regulation and policy so all people can access the sustainable, dependable and affordable energy and water they need. We ensure consumer protections improve equity and limit disadvantage and support communities to play a meaningful role in decision-making. We help to accelerate a transition away from fossil fuels that also improves outcomes for people. We work collaboratively with community and consumer groups across the country, and our work receives input from a community-based reference group whose members include:

- Affiliated Residential Park Residents Association NSW;
- Anglicare;
- Combined Pensioners and Superannuants Association of NSW;
- Energy and Water Ombudsman NSW;
- Ethnic Communities Council NSW;
- Financial Counsellors Association of NSW;
- NSW Council of Social Service;
- Physical Disability Council of NSW;
- St Vincent de Paul Society of NSW;
- Salvation Army;
- Tenants Union NSW; and
- The Sydney Alliance.

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The Justice and Equity Centre office is located on the land of the Gadigal of the Eora Nation.

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1. Introduction

The Justice and Equity Centre (JEC, formerly known as PIAC) supports some, but not all, of the measures that Transgrid has proposed to manage the issues associated with cost recovery for non-network options (NNO).

We agree that there are instances where both Transmission Network Service Providers (TNSPs) and consumers can benefit from reduced uncertainty regarding ongoing cost recovery. However, we do not agree that NNO cost-smoothing for either consumers or TNSPs is a problem that requires solving.

Our input is based largely on two key considerations:

- The consideration of cost recovery for NNOs, be it the financeability impacts or the implications for which actors hold different quantums of risk and how they are compensated for this, should be assessed in relation to their impact the transmission network service provider (TNSP) as a whole. It should not be considered on a project-by-project basis. The revenue framework for transmission businesses generally aims to regulate TNSPs on an overall basis. Likewise, recent rule changes regarding financeability aim to ensure the issue is managed with reference to the business as a whole. It does not seek to solve financeability issues on a project-by-project basis.

- Risks are best held by the parties empowered to most effectively and efficiently manage them. Consumers are rarely the most well-positioned stakeholder either to manage risks or to select the efficient level of risk to hold.

2. Problem definition

It is true that TNSPs carry risks when proposing and executing NNOs, and are not compensated for these risks in any direct way. However, this is only a problem if it can be established that TNSPs are selecting NNOs at rate that is less optimal for consumers. The risk and compensation rates for TNSPs are considered with reference to the TNSP as a whole, not on a project-by-project basis. The fact that TNSPs do not have the opportunity to earn returns on NNOs is not a problem to be solved in isolation.

Initial cost recovery uncertainty

The JEC does not agree that TNSPs entering into agreements with NNO providers before the Australian Energy Regulator (AER) approves the costs introduces risks which pose a material barrier to NNOs being deployed efficiently.

The Regulatory Investment Test for transmission (RIT-T) requires proponents to consider NNOs alongside network options to solve for identified needs, and the robustness of this structure is not in question for the purpose of this rule change.

The regulated revenue TNSPs receive on their regulated asset base is generous, and this is in part to compensate them for roles played elsewhere, including the stewardship of NNOs. While we agree that if NNOs alone were increasing in value, this arrangement may be less reasonable,

the current situation is characterised by increasing NNO investment alongside increasing network investment. There is no reason to assume expenditure on NNOs is increasingly disproportionately, and so we consider arrangements for TNSPs to manage the risks associated with opex spending remain appropriate.

We are concerned that while the current structure provides some incentive for the TNSP to reduce the costs of the NNO, none of the proposed solutions appear to do so. On this basis we support the arrangement – where the TNSP both conducts the negotiation with the NNO provider and holds the associated risk – remaining in its current form.

Ongoing cost recovery uncertainty

The JEC agrees there is scope to increase the certainty of ongoing cost recovery for consumers in a way that is in the interests of both consumers and TNSPs.

Cost recovery timing

The JEC does not agree that lumpy cost recovery imposes a substantial cost for consumers.

Expansion of NNO deployment is unlikely to be temporary. It is much more likely to be an ongoing feature of the market moving forwards, meaning there will be more or less consistent additions to transmission use of service (TUOS) from this source. The volatility that wholesale markets add to energy prices is likely to be a more significant contributor to volatility.

We do not consider TNSPs have a meaningful role in smoothing energy costs for consumers. The purpose of retail providers is the bundling of energy system costs, and their smoothing through aggregation, hedging and other risk management tools. The task of cost smoothing should remain with the party best placed to conduct it: retailers.

Concern regarding potential disutility consumers may experience from lumpiness in TUOS – which is unlikely to be material - should be disregarded.

Financeability for TNSPs is being managed via other new instruments, both the concessional finance arrangements and the new powers of the AER arising from the *Accommodating financeability in the regulatory framework* rule. We see no reason (and potential risks) in adding yet more mechanisms to 'solve' it again here. We note that the *Accommodating financeability* framework considers the businesses on a holistic basis, rather than on a project by project one, and so is specifically designed to cover more than the dynamics arising directly from new large network projects.

3. Assessment of solutions

As noted above, the JEC's assessment of the proposed solutions makes reference to two key principles:

- that the solutions should be neutral to the overall risk and compensation levels of TNSPs, and
- that risk is generally best held by parties that are most able to effectively and efficiently manage them.

Regarding the first point, the fact that risk and compensation levels relate to the business as a whole implies that a change in the compensation arrangements one type of risk should imply an adjustment in the compensation that is targeted for other activities of the TNSP. That is, if the compensation for risks associated with NNOs goes up, we would expect the compensation for other activities to go down. This is the only way the resolution could not result in an overall increase in the regulated rate of return relative to each level of risk held by a TNSP.

While some of the solutions proposed in the consultation paper are revenue and risk-quantum neutral for the TNSPs, the solutions which are not do not appear to consider the need to adjust other elements of the revenue framework, let alone propose any specific adjustments to offset the impact of the changes proposed.

Regarding the second principle, while consumers ultimately pay for network and non-network investments, they have very little capacity to ensure that decisions are conducted in a way which minimises costs. We are wary of moving risks relating to NNOs from TNSPs, who are well-informed and well-positioned to manage those risks on behalf of consumers, to consumers. We are also wary of removing a mechanism that incentivises TNSPs to drive down costs without replacing it with a new mechanism which provides the same level of incentive. Some of the proposed solutions in this rule change risk doing this.

Introducing an ex-ante approval process and bringing cost recovery forward

The JEC does not support this proposal.

The regulatory framework does not aim to de-risk each individual investment or have revenue returned at an exact level relating to the level of risk of that investment. Rather, it aims to compensate the regulated business as a whole, commensurate with the risk held across that business. If an adjustment reduces the risk held by a TNSP as a result of the existing arrangement – ie. the AER approving costs after the TNSP enters into an agreement with an NNO provider – this adjustment must be accompanied by a commensurate reduction in the compensation the business receives as a whole. There is no mechanism in the proposal for that to occur.

We are also concerned that with capacity to pass costs through to consumers in full, the incentive for TNSPs to minimise the costs of NNOs may be reduced or eliminated.

We agree with the AEMC's analysis that the benefit of avoided time-value compensation only arises to the extent that consumers' time value of money is below the allowed rate of return at which TNSPs are compensated. If there is a difference, it is unlikely to be a material one.

Regarding concerns relating to TNSP balance sheets or financeability, as noted above, we contend these issues have been appropriately and adequately managed elsewhere.

Adjustments to the network support payment allowance

The JEC supports this proposal provided the AER is able to produce guidance with adequate granularity about what types of contingencies can lead to adjustments.

We agree with the AEMC's concern that such an arrangement would require the AER to make calls on the appropriateness of various payment variation terms ex ante when there is limited

information available to the AER regarding the likelihood and quantum of potential payments. However, for some of the contingencies Transgrid raises the risks are relatively definable.

For contingencies that are able to be defined relatively clearly in terms of probability and quantum of payment, and for which a TNSP is not well-placed to manage the risk – for example, the possibility of a partner organisation declaring bankruptcy – both the TNSP and consumers are best served by allowing the AER to adjust the network support payment allowance.

The alternative to this is for TNSPs to inflate the costs of NNOs in order to mitigate the possibility of these events arising (for example, by selecting partners that are not the most competitive, but are more reliable). This would not be in consumers' interest.

More frequent adjustment to the network support payment allowance

The JEC does not support this proposal.

For the reasons given in section 2.3 above, we contend cost-smoothing is not a relevant concern for TNSPs.

The benefit to consumers from reducing time value compensation for TNSPs is immaterial.

TNSP financeability concerns are already being managed more effectively via other means.

4. Continued engagement

We welcome the opportunity to meet with the AER and other stakeholders to discuss these issues in more depth. Please contact Michael Lynch at mlynch@jec.org.au regarding any further follow up.